

Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable Hilda L. Solis,
United States Secretary of Labor

Hedge Funds and Private Equity Investments

November 2011

November 9, 2011

Dear Secretary Solis:

The 2011 Advisory Council on Employee Welfare and Pension Benefit Plans is pleased to present its Report on Hedge Funds and Private Equity Investments.

The Council has a diverse membership drawing from both profit and not-for-profit entities and representing various stakeholders in the provision of employee benefits to American workers and their families. We have a shared commitment to improving the provision of those benefits. This has enabled us to reach a consensus on a number of matters relevant to the issues we have examined.

The attached report was prepared after two days of testimony by 10 witnesses followed by discussion and deliberation by the Council.

We wish to gratefully acknowledge the assistance of all persons listed under “Acknowledgements” and, in particular, Larry Good and DiWeena Streater of the Employee Benefits Security Administration.

Respectfully submitted,

/s/

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November 2011 ERISA Advisory Council Report on Hedge Fund and Private Equity Investments

NOTICE

This report was produced by the Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (the “Council”). The Council was established under Section 512 of ERISA to advise the Secretary of Labor. This report examines Hedge Fund and Private Equity Investments. The contents of this report do not represent the position of the Department of Labor (DOL).

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ABSTRACT

The 2011 ERISA Advisory Council (the “Council”) examined the investment of ERISA plans in hedge funds and private equity funds, the risks associated with these investments, and the process plan sponsors are taking to evaluate their appropriateness as investments in pension benefit plans. The purpose of the Council’s examination is to provide recommendations to the Department of Labor (“DOL”) on guidance for plan sponsors, such as suggested best practices, for purposes of evaluating the investment strategies for and monitoring the investment of retirement plan assets in these investment options in a manner that is consistent with the obligations of plan sponsors as fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

Through testimony and research, the Council developed a tip sheet, that certain plan sponsors may find beneficial when evaluating whether to invest retirement plan assets in hedge funds and/or private equity funds, and for the ongoing monitoring of such plan investments.

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I. EXECUTIVE SUMMARY

The 2011 Council examined the investment of retirement plan assets in hedge funds and private equity funds, the role of these investments in the plan's investment portfolio, and the risks associated with these investments. In part, due to market volatility in recent years, plan sponsors have increased investment of defined benefit (DB) pension plan assets in certain investments that may not be generally recognized by the average person as "traditional" pension plan investments such as equities or bonds that are traded on the open market. Some of the reasons for this surge of interest in investing in hedge funds and/or private equity funds that were stated to the Council in testimony include (1) the fiduciary's need to increase diversification of plan assets; (2) an attempt to decrease the volatility within the plan that has been, in recent years, associated with traditional investments; and (3) an effort to enhance the plan's overall investment performance.

Although investing in hedge funds and/or private equity funds may offer some value there may be more inherent risks and complexities that are associated with hedge fund and private equity investment strategies, thereby requiring a greater level of investment sophistication both at the initial stage of the investment, and on an ongoing basis.

The Council studied fiduciary issues relative to the prudent selection and monitoring of these investment options. In particular, the Council heard witness testimony regarding the use of these investment options by plans, the due diligence processes that are used by retirement plans and their advisers, use of hedge fund indices to assess performance, the level of regulation applicable to hedge funds and private equity funds, and the various types of risks generally associated with these investments. Witnesses who testified before the Council included investment managers for hedge funds and private equity funds and funds of funds, attorneys that counsel regarding these investments, investment advisers that provide investment advice to plan sponsors regarding the investment of retirement plan assets, and representatives of EBSA and GAO.

Questions regarding how plan sponsors could better understand the risks generally associated with these investment portfolios were addressed. The major issues discussed included the plan sponsor's need to address the following:

1. Identification of the type of due diligence required in making the investment;
2. Understanding the liquidity needs of the plan;
3. The application of an ERISA requirement that plan assets must be diversified;
4. The application of the "prudent investor rule" in which a plan fiduciary has the obligation to consult with individuals or entities who have the necessary expertise regarding these investments when the fiduciary does not possess the expertise itself;
5. The underlying long-term investment goals of the pension plan, and how this aligns with the investment goals of the hedge fund or private equity fund;

6. The fee structure of the investment option being considered and the transparency of the investment option, or lack thereof;
7. The ability and opportunity to evaluate the expertise of the investment manager of the investment option being considered; and
8. The ability to value the investment option being considered, the investment return of such investment, and the compatibility of these factors with the pension plan.

The Council recommends that DOL provide a tip sheet containing general questions and answers designed to assist DB plan sponsors in (i) evaluating the appropriateness of investing pension plan assets in hedge funds, private equity funds, and funds of funds that invest in hedge funds or private equity funds, and (ii) selecting and monitoring the investment of pension plan assets in these investment options (including the utilization of a fund of funds and/or other investment professionals). While the Council's recommendation expressly applies only to DB plans, the Council believes that certain items in the tip sheet may be helpful to investment fiduciaries of defined contribution (DC) plans who may consider these investments as possible options.

To assist DOL in preparing the recommended tip sheet, the Council included as part of this report a suggested tip sheet which includes guidance on the definition of "hedge funds" and "private equity funds", tips on how to evaluate whether these types of investment options are appropriate investments for the pension plan (with particular focus on the fund's specific investment strategies) and addressing the need for the necessary expertise to adequately evaluate the investment options being considered, the level of transparency associated with the investment options, and the duties and factors involved to support the performance of investment, legal and operational due diligence.

In addition, the Council studied whether these types of investments may be held by defined contribution plans and whether it would be appropriate to do so. Witness testimony varied on whether it would be considered prudent for a plan sponsor to invest the assets of a DC plan in these non-traditional investments on a standalone basis. The Council reviewed some of the constraints under the Securities law for participant-directed DC plans. The Council also heard testimony regarding the inclusion of hedge funds and/or private equity funds as part of the target-date funds or lifecycle funds.

II. RECOMMENDATION

The Council recommends that DOL should develop a tip sheet designed to assist plan sponsors in evaluating the appropriateness of hedge fund and/or private equity fund investments, and in selecting and monitoring these investments in DB plans. The Council believes that the tip sheet should address how to evaluate the expertise of the fund manager, challenges of assessing performance and performance data biases, due diligence processes, fees, and legal, operational and other risk factors.

III. BACKGROUND

A. Characteristics of hedge funds and private equity funds

Many large defined benefit plans are currently investing in hedge funds and/or private equity funds. According to a GAO survey of large defined benefit plans, 92 percent had some percentage of plan assets invested in private equity and 60 percent had some percentage of plan assets invested in hedge funds as of 2010.¹ The growing popularity of such so-called “alternative investments” among the fiduciaries of large pension plans, and the perception that these investments have performed well and decreased plan exposure to market volatility has created increased interest in these investment options among mid-sized and smaller plans. In addition, the well-publicized success of some institutional money managers in investing in hedge funds and private equity funds, notably for some of the large university endowments, has led to further interest being developed in such investments. The level of interest has risen such that some plan fiduciaries may believe that they could be failing in their duties if they do not consider, and possibly include, hedge funds and/or private equity funds as investment options in their DB pension plan portfolios.

Interest in hedge funds and private equity investments has grown in the defined contribution plan area as well, with some plan fiduciaries choosing to offer investment alternatives that contain these strategies. On the other hand, some plan fiduciaries believe that these investments are not appropriate, at least as a standalone option in DC plans. An example of the view that hedge funds should not be made available as a standalone option in DC plans was set forth by AARP in a letter that is contained in the record to this report.

Although the term “hedge fund” is widely used, it does not have a technical definition. Rather it refers to a diverse group of funds that are not registered with the Securities and Exchange Commission (“SEC”). Hedge funds invest in different types of assets, *e.g.*, long and/or short positions in exchange traded securities, exchange traded and off-exchange derivatives, currencies, commodities and different types of investment products. They often use relatively high levels of leverage. As such, hedge funds do not constitute an asset class but rather provide access to particular trading strategies that may be employed by specific fund managers.²

The term “hedge fund” originally arose as a reference to the idea that such funds provide a hedge, or risk reduction, compared to an investment in the stock market. Many hedge funds use the stock market as a reference point and attempt to provide smoother returns and low correlation with the market. On the other hand, many other hedge funds take on complex risks in search of higher returns with little or no reference point to the stock market. Yet there are other types of hedge funds, such as long-only funds that may have a high correlation with the stock markets. Given this diversity among hedge funds, it is virtually impossible to characterize the likely investment performance of hedge funds linked together as a group.

¹ Testimony of Barbara Bovbjerg on behalf of the GAO.

² This point was emphasized in the statement submitted by General Motors Investment Management Corporation, also known as GM Asset Management.

Another hedge fund investment option available to the pension plan investment is through a fund of funds option. Some plans invest in hedge funds by investing in a fund that invests in hedge funds. Similarly, plans may have exposure to private equity fund investments by investing in a fund that invests in private equity funds. This type of fund of funds investing provides certain benefits to the pension plan by providing access to funds that are not directly available to the plan. Also, this option increases diversification of the pension plan's portfolio, and shifts some of the due diligence function, as well as an ongoing oversight of the investment, to the investment professionals associated with the funds. It is important to note that even with the advantages of fund of funds investment options, there are also certain disadvantages associated with this investment option, as they involve additional fees and costs at the fund of funds level, and less transparency of the underlying funds and investment components.

While hedge funds and private equity funds share some important characteristics (e.g., the fund is not registered with the SEC), they are very different types of investments. Private equity funds are pooled investment vehicles that typically make investments in companies that do not have publicly traded equity. Very often, those who manage the funds are also involved in managing the businesses they acquire. Private equity funds provide access to companies that cannot normally be purchased through traditional investment vehicles of the stock markets. As such, private equity funds provide access to a separate asset class. Investment in such funds may provide plan sponsors with the opportunity to provide valuable diversification within their pension plan's investment portfolios. However diversification is only one factor to be considered in evaluating whether the private equity fund is an appropriate investment for the pension plan including, but not limited to, whether the necessary due diligence can be executed. Another potential drawback with private equity funds is the lack of liquidity that is characteristic of this type of investment.

B. Previous DOL Guidance and Recommendations for Best Practices

Existing ERISA requirements with respect to investing pension plan assets in hedge funds and private equity funds derive from ERISA Section 404(a) requirements that a plan fiduciary must carry out his/her duties with the care, skill, prudence and diligence of a knowledgeable person under similar circumstances, including the duty of investing plan assets. The plan fiduciary also has a duty to diversify plan assets and to follow the terms of the plan. To act prudently in selecting plan investments, a plan fiduciary must give appropriate consideration relative to the plan's portfolio regarding investment diversification, risks associated with the particular investment, investment liquidity and other investment return characteristics. If the fiduciary does not have the requisite expertise to make an informed decision regarding a particular investment option, in order to fulfill his/her duty of prudence, the fiduciary must consult with someone who is an expert in that area. Additionally, in exercising prudence in selecting an investment option, a fiduciary cannot blindly rely on recommendations from third parties to make investment decisions.

In a March 21, 1996 Information Letter to the Comptroller of the Currency, Eugene Ludwig (the "Ludwig Letter"), regarding the investment of ERISA plan assets in derivatives, the DOL indicated that the same fiduciary standards would apply when plan assets are invested in derivatives as when the assets are invested in other investments. Under the Ludwig letter, the

plan fiduciaries are required to engage in the same general procedures and make the same type of analysis of the investments being considered as with other investment decisions. This effort would include understanding how the investment fits within the plan's investment policy, the plan's potential for losses and an evaluation at the time of initial investment and, as appropriate, on an ongoing basis, of market, credit, legal and operational risks. Fiduciaries should have the requisite expertise to understand the investment, as well as the personnel, control and resources to perform the appropriate analysis, or in the alternative, engage outside experts for such purposes. In discussing the fiduciary requirements when plan assets are invested in a pooled investment fund with derivatives, the Ludwig Letter indicates that the plan fiduciary should understand the role of derivatives in the pooled investment fund. The Council examined how the Ludwig letter would apply in the case of the investment of plan assets in hedge funds and private equity funds.

When assets of a pension plan are invested in hedge funds and/or private equity funds, if less than 25 percent of the equity interest of every class in a hedge fund or private equity fund is held by "benefit plan investors," assets of the fund are not plan assets under ERISA, with the result that the investment manager of the fund is not an ERISA fiduciary. ERISA Section 3(42); 29 CFR Section 2510.3-101. An additional exception from plan asset status may be available to private equity funds that satisfy the requirements to be considered a "venture capital operating company." The "25 percent test" was modified by section 611(f) of the Pension Protection Act in 2006 so that (i) the term "benefit plan investor" no longer includes public plans, non-U.S. plans and other plans not subject to ERISA and (ii) funds investing in the fund are only counted as benefit plan investors to the extent of the percentage interest in the investing fund held by benefit plan investors. Perhaps partly in response to this change, there has been a significant increase in ERISA governed plan assets being invested in hedge funds in recent years.

In the Council's November 2006 report on Prudent Investment Processes, the Council recommended that DOL publish best practices guidance on the unique features of hedge funds and include matters that should be considered when plans invest in hedge funds.³ The GAO has also published a report recommending that the Secretary of Labor provide guidance specifically for ERISA plans on investing in hedge funds and private equity funds.⁴ The Council also studied aspects of hedge fund investments as part of its 2008 study on Hard to Value Assets and Target Date Funds.⁵

In 2009, the Investors' Committee established by the President's Working Group on Financial Markets published a report on best practices for hedge fund investors, which includes a Fiduciary

³ Advisory Council on Employee Welfare and Pension Benefit Plans, Report of the Working Group on Prudent Investment Process, 2006.

⁴ U.S. Government Accountability Office, Defined Benefit Pension Plans: Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity, GAO-08-692 (Washington D.C.; Aug. 14, 2008).

⁵ Advisory Council on Employee Welfare and Pension Benefit Plans, Report of Hard to Value Assets and Target Date Funds, 2008.

Guide for those overseeing the investments.⁶ The Investors' Committee consisted of public and private pension plans and endowments that invest in hedge funds and other parties.

C. Other legal considerations for DB and DC plans

Unlike mutual funds and other registered investment companies, hedge funds and private equity funds escape the registration requirement under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") by restricting the type of investor who can invest in a hedge fund or private equity fund to either an "accredited investor" under Section 3(c)(1) of the 1940 Act or a "qualified purchaser" under Section 3(c)(7) of that Act. An "accredited investor" includes any ERISA pension plan with more than \$5 million in total assets, an ERISA plan with fewer assets if the investment decision is made by an ERISA plan fiduciary which is either a bank, savings and loan association, insurance company, or registered investment adviser, and a participant-directed ERISA plan in which plan participants are "accredited investors."⁷ A "qualified purchaser" includes any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than \$25 million in investments.⁸

Under SEC guidance, when a plan participant in a participant-directed defined contribution plan can direct the investment of a portion of his or her account in the plan into a 3(c)(1) or 3(c)(7) fund, the plan participant must qualify for accredited investor or qualified purchaser status because the plan participant is treated as the beneficial owner of the fund. However, if the plan participant can only indirectly invest in such a fund because the fund is part of a generic investment option under the plan and the plan participant can invest in the generic investment option but has no discretion to invest in the fund, the plan, rather than the plan participant, will be treated as the beneficial owner of the fund and must comply with the 3(c)(1) or 3(c)(7) requirements.⁹ The Council understands that participant-directed DC plans may have exposure to hedge funds and/or private equity funds when the plan includes as part of its investments options target-date funds, lifecycle funds or other managed funds which may invest a portion of their assets in hedge funds and/or private equity funds.

⁶ Investor's Committee, Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets, January 15, 2009.

⁷ Rule 501 of Regulation D, Securities Act of 1933.

⁸ Section 2(a)(51)(A) of the Investment Company Act of 1940.

⁹ Under SEC no-action guidance, the plan, rather than plan participants, is the beneficial owner of the fund held by a generic investment option under the plan if (i) the decision to invest the generic investment option in the fund is made by one or more plan fiduciaries without any involvement of plan participants, (ii) the plan's participant's only discretion is to choose the generic investment option, not the investments that comprise the generic investment option, (iii) the fund cannot be more than 50% of the generic investment option, and (iv) no representation can be made to plan participants that there will be any investment in the fund and a disclaimer must be given to participants every time the fund is mentioned telling plan participants that there is no assurance that the plan will continue to invest in the fund. See H.E. Butt Investment & Retirement Plan, SEC no-action letter (publicly available May 18, 2001).

IV. SUMMARY OF TESTIMONY AND COUNCIL DISCUSSION

A. Rationale for Council's Recommendation

The Council heard testimony from a number of industry participants, including managers of hedge funds, private equity funds, and funds of funds, a manager of a target-date fund suite that invests in hedge funds and private equity investments, as well as other types of alternative investments, and consultants and advisers who advise plan sponsors on hedge fund and private equity fund investment. The Council also heard testimony from Hedge Fund Research, Inc. ("HFRI"), which has established different indices and databases for evaluating hedge fund performance, and representatives from GAO, which has conducted several reviews of hedge fund and private equity fund investment activity by defined benefit plans and other institutional investors. Testimony was also received from two lawyers who counsel plan sponsors on these investments, as well as from Lou Campagna, Chief of the Division of Fiduciary Interpretations, EBSA's Office of Regulations and Interpretations.

In his testimony before the Council, Mr. Campagna confirmed that the analysis in the Ludwig Letter, although focused on derivatives, may be applicable to apply to pension plan investments that are invested in hedge funds and/or private equity funds. He also confirmed that EBSA does not impose quantitative limits on a plan's investments in alternative investments but rather EBSA evaluates the appropriateness of the investment under ERISA's general fiduciary and prudence standards. Also, he indicated, unless the hedge fund or private equity fund contains plan assets, that the manager of the hedge fund or private equity fund need not be an ERISA fiduciary.

After receiving comprehensive testimony from the witnesses, the Council members discussed what conclusions they had drawn that could provide the basis for recommendations to DOL. From the testimony, the Council understands that many large plans have the ability and resources to conduct the appropriate level of due diligence required to support investments in hedge funds and/or private equity funds. Several of these large plans, and the practices they established contributed to the work of the Investors' Committee established by the President's Working Group on Financial Markets regarding best practices for hedge fund investments. Despite the existence of such resources, the Council is particularly concerned about whether sponsors of mid-sized and small plans are experienced enough, or have the adequate resources to effectively evaluate the complexities of these investments and to make a prudent decision on whether to invest in such investment options. From the testimony presented, the Council believes that these plans are not likely to be handling the due diligence process themselves, but rather are likely to have the due diligence of the hedge funds and/or private equity funds conducted by the manager of a fund of funds, or an outside investment firm retained by the plan sponsor. However, in such cases, plan sponsors cannot blindly rely on their professionals' opinions and advice, given that plan sponsors are obligated under the prudent investor requirement of ERISA to retain independent professionals who have the requisite knowledge to assist the plan sponsors in understanding the nature of these investments and how they may affect the plan's overall investment performance, and must have an understanding of what the professional is doing and recommending.

The Council concluded that it would be most helpful if DOL issued a tip sheet for DB pension plan fiduciaries seeking to invest in these types of investments. Hedge funds and private equity

funds have additional levels of complexity that makes them quite different from traditional investing in publicly traded asset classes. The hedge funds and private equity funds are generally illiquid and non-transparent investments. They may have complex fee and pay-out structures that make comparisons across funds difficult. Because of these and other important differences compared to traditional investing, plan sponsors need guidance as to whether to participate. Given the complexity of the hedge fund and private equity marketplace, plan sponsors also need guidance on how to participate in this market.

The Council concluded that the tip sheet should first address the major factors used to evaluate the appropriateness of a hedge fund and/or private equity fund as an investment for the pension plan. Appropriateness depends on a number of factors, including how the investment fits within the pension plan's investment policy and how the investment option helps to meet the investment goals of the plan's portfolio. Appropriateness of the investment option is also dependent on whether the plan sponsor sufficiently understands the investment option to enable the pension plan sponsor to conduct (or caused to be conducted) the appropriate due diligence that would be required when investing the plan assets in a hedge fund and/or private equity fund on an ongoing basis.

The Council believes that the tip sheet also should address the due diligence concerns and the processes involved when making the decision to invest pension plan assets in hedge funds and/or private equity funds with some additional level of attention given to the different approaches that may be taken, when due diligence is conducted by an outside adviser, or when the pension plan chooses to use a fund of funds investment option.

In effort to assist the DOL in preparing a tip sheet, the Council has included a sample tip sheet in the report and which is set forth in Section IV.C of the report. Section IV.B of the report provides additional comments and explanations of the sample tip sheet based on witness testimony and subsequent Council discussion and deliberations.

The Council members discussed additional points that were brought forth by the witnesses and that are relevant to all plans. Although it was acknowledged that DB plans (particularly large plans) have been investing in hedge funds and private equity funds for quite some time, there is still a need for some guidance with respect to the level of investor prudence that should remain a focus, in large part, because the level of prudence needed with respect to investing in such investments is significantly different than more typical "traditional investments." Such investor prudence includes, but is not limited to, evaluating the extent of risks and leverage that the pension plan can tolerate. This should include reviewing the pension plan's participant census to determine whether these particular investments could lead to liquidity issues for the plan in the immediate or not too distant future. Fund manager selection is critical.

For a fund of funds, a plan sponsor should look at the performance of the underlying managers of the investments and also consider that a fund of funds tends to have a higher fee structure. In all cases, the plan sponsor should evaluate the investment's fee structure and consider its tolerance for a lack of transparency compared to traditional investments, which may include a lack of transparency involving the investment manager's method for obtaining maximum returns on investments.

Furthermore, the Council discussed issues related to the manner in which hedge funds and private equity funds are valued and what impact the valuation methods have on determining the exact return on investment at any particular time, the means for an independent auditor to address this issue, and also the impact valuation methods may have on liquidity.

B. Discussion of Tip Sheet

1. Appropriateness of Investing in Hedge Funds and Private Equity Funds

The first consideration to be made is whether a pension plan should invest assets in hedge funds and/or private equity funds at any level. Even in cases of very large pension plans, generally, relatively small proportions of the plan assets are invested in hedge funds and/or private equity funds.¹⁰ Because individual funds may be quite risky, either because of the investment strategy employed or because of operational risk factors, it is important for a pension plan to consider diversification when these types of investments are selected for the plan. The complexity involved in evaluating and monitoring these funds, and the requirement to diversify investments in a pension plan portfolio means that substantial resources and expertise are needed to invest in private equity and/or hedge funds. These factors may make investment in private equity and/or hedge funds inappropriate for smaller pension plans or other funds that have limited resources and sophistication necessary for evaluating the investments.

However, if the plan sponsor chooses to invest plan assets in hedge funds and/or private equity funds, it must develop and implement an overall strategy designed to govern these investments. There are many choices available among different sorts of hedge funds and/or private equity funds, as well as funds of funds. The plan sponsor should carefully evaluate what type of investment strategy is compatible with the plan's broader goals and the other investments in its portfolio, and the benefit obligations under the plan.

Investing through a fund of funds approach provides an alternative way for the pension plan to access investments in the hedge fund or private equity fund sectors. However, the presence of two layers of fees that apply in funds of funds – one for the aggregator and one for the individual funds – may reduce expected returns in these vehicles.

Another point of concern regarding these investments is they are less liquid than traditional investments. Investments in hedge funds may be relatively illiquid, with private equity funds being typically substantially more illiquid than hedge funds. It also may be difficult to determine the current value of the funds as they may themselves invest in illiquid assets, especially in the case of private equity funds. The illiquid nature of these investment vehicles requires that the plan sponsor carefully consider how that lack of liquidity will reconcile with its funding needs and the rest of its portfolio.

The selection of individual funds creates additional challenges. Hedge funds and private equity funds are not required to disclose details concerning their overall investment strategy, particular investment holdings or the degree of leverage being used, although some may choose to disclose

¹⁰ See GAO report and testimony of Russell Steenberg.

some limited information on these matters. This lack of transparency may make it more difficult to evaluate how investments in such funds fit within the pension plan's overall investment strategy. While the past performance of hedge funds may provide some information, their strategies can change over time, leading to wide variations in performance.¹¹

2. Evaluating Past Performance

An academic investigation of hedge fund performance has found that, on average, hedge funds earn excess returns at a level that at least cover their substantial management fees.¹² However, this research has largely found the excess return, or alpha, to be statistically insignificant.¹³ This is because of the very large variation in performance across different hedge funds. The Council heard mixed testimony regarding the performance of these types of investments. Some witnesses testified that hedge funds and private equity investments consistently, and historically, outperform more traditional strategies. On the other hand, the AARP stated in its letter (contained in the record to this report) that hedge fund and private equity investments do not necessarily outperform more traditional investments.

While, as noted above, changing fund strategies can lead to large variations in fund performance, academic research does indicate that there is some persistence in fund performance, so that investing in a historically well-performing fund has value, on average.¹⁴ Thus, it is important to investigate the fund management and historic performance.

Indices of hedge fund performance may help provide a benchmark to help evaluate potential fund investments. However, index construction is especially difficult for hedge funds because of the variety of different hedge fund strategies, and the substantial rate of turnover among funds being created and funds being closed. New funds may choose not to report returns unless they have a run of successful returns with the effect of creating selection bias. Closed funds may disappear from indices, thus, creating survivorship bias. Because of these sorts of potential biases, indices may tend to provide an overly rosy view of the performance of the hedge fund industry.

A difficulty with investing in both high-performing hedge funds and/or private equity funds is that many of these funds are closed to new investors when adequate funding is received from existing investors. This is another consideration that may also contribute to making indices of fund performance unreliable for investors who are looking for new investment options as these indices will typically include funds that are essentially unavailable.

¹¹ In one well-reported example, the Paulson and Co. hedge fund earned spectacular returns taking short positions on the housing market but subsequently suffered substantial losses as a result of large investments in completely different markets. Even classifying the type of strategy of a fund of this nature is difficult.

¹² See Rene M. Stultz, "Hedge Funds: Past, Present and Future," *Journal of Economic Perspectives*, 21, 2007. This paper provides a helpful summary of academic research on hedge fund performance.

¹³ *Ibid.*

¹⁴ *Ibid.*

Private equity funds have different issues from those stated above for hedge funds. Because they are generally closed-end, finite horizon funds, a particular fund will usually have no track record available to evaluate. Indices for private equity fund performance may share some of the same biases noted for hedge fund indices, although there has been limited research on this topic. Despite this, the performance of earlier funds by the same manager may be an informative source to consider. Because private equity funds largely invest in non-traded assets, more of the investment returns may be attributed to the fund manager's skills rather than to the hedge funds investing in traded securities.¹⁵ As with hedge funds, there is a broad dispersion of performance across private equity funds, making evaluation of the fund's management especially important.¹⁶ Some academic research has indicated that some fund managers were able to achieve above-average returns with some consistency.¹⁷

3. Evaluating Fees

Investments in either hedge funds or private equity funds generally have substantial fees. These fees usually include (i) a management fee that is charged as a percentage of assets under management and (ii) a performance fee. Some of these fee arrangements can be complex, especially for private equity funds. There may be additional fees for placement, early redemption of the investment, and for administration.

Because there are multiple levels of fees that may be charged, it is important to evaluate the entire fee structure to get an overall picture of likely costs associated with the investment option. These likely costs should be weighed against the possible benefits of diversification that are offered by these investments.

With respect to investments for private equity funds, the performance fee, or "carried interest" may have a level of complexity that makes it difficult to compare the fee structure with fees assessed at other funds. Also, there may be provisions for "claw backs" in which fees already paid to management may be partly refunded to investors if multi-year contractual benchmarks are not reached. Because of the complexity of such arrangements, it may be helpful for the plan investment fiduciary to test the fee structure by examining the fees that would result from sampling a range of different return scenarios.

4. Evaluating Liquidity

As discussed above, investments in hedge funds, and especially in private equity funds, are relatively illiquid. For private equity funds there is often a capital commitment period of three to five years with the possibility of such an investment being locked in for more than 10 years. Given this illiquidity, it is critical that if these investment options are selected for the pension plan, adequate provisions are made to match the overall liquidity structure of the investment portfolio with the need to pay out benefits under the plan. The need for a minimum overall level

¹⁵ This is because, to the extent that securities are traded in informationally efficient markets, it is difficult to reliably earn excess returns. The Steenberg witness statement provides useful additional information concerning the potential contributions of private equity managers.

¹⁶ See Steenberg witness statement.

¹⁷ *Ibid.*

of liquidity to meet pay-out requirements will, for most plans, limit the percentage of plan assets that should be invested in private equity funds. Larger plans may be able to invest a greater percentage of their assets in private equity by investing in a sequence of different funds at different dates.

5. Issues Relating to Monitoring and Due Diligence

As noted above, the complexities involved in investing in hedge funds and private equity funds make it important for plan sponsors considering such investments to evaluate carefully whether it has the necessary time and expertise associated with the selection and ongoing monitoring of these investment options. Because of the wide dispersion of returns to these funds, poorly selected funds could be damaging to a pension plan's investment portfolio.

One possible solution could be retaining an independent investment adviser who has expertise in evaluating and monitoring these types of investment options. It is important to note that hiring such an adviser will add another layer of fees to the cost of selecting the investment option. When choosing an investment adviser it will be important for the plan's investment fiduciary to understand how the adviser intends to create, and then monitor, a diversified portfolio. It will also be important to understand how the adviser performs risk analysis and due diligence.

Moreover, some of the complex trading strategies of hedge funds, involving high degrees of leverage and use of derivatives, may generate substantial credit risk and operational risk, issues which may not be familiar areas of due diligence for plan investment fiduciaries who generally invest plan assets in more traditional investments.

From a legal due diligence perspective, it is important for the plan to retain legal counsel who has experience in this area. Counsel should ensure that the investment is consistent with the plan's investment policy statement, the plan and general fiduciary principles as set forth in ERISA Section 404(a), and the Ludwig Letter referenced above. Counsel should review all the documentation relevant to the hedge fund and/or private equity fund, including documents that will affect the plan's rights, responsibilities and liabilities when it invests in a hedge fund, private equity fund, or a fund of funds. This documentation will include the fund's offering memorandum, due diligence questionnaire, operating agreements, subscription agreement and side letters. It is also important to determine whether the investment manager of the hedge fund or private equity fund, or the investment manager of the fund of funds, is a fiduciary under ERISA because the assets of the hedge fund, private equity fund, or fund of funds are ERISA plan assets. If so, the fund manager will share fiduciary responsibility for the management of those assets.

Due diligence on operational risk should be focused on the funds' tools for handling operational risk. This will include the funds' operational, legal and compliance staff, as well as disaster recovery and back-up systems. Funds also depend on the integrity of third party organizations with which they work. Thus, it may be valuable to examine the reputations of a fund's prime broker, custodial bank, accountants and legal counsel.

C. Suggested Sample TIP Sheet

Tips for Plan Sponsors to Consider when Evaluating a Hedge Fund or Private Equity Investment for a Defined Benefit Pension Plan

ERISA imposes a standard of care on ERISA fiduciaries in choosing investments for a pension plan that includes giving appropriate consideration to the facts and circumstances that a fiduciary knows, or should know, about a particular investment option. This standard of care includes a duty to evaluate the role an investment option plays in the plan's portfolio, including whether such investment option would further the purposes of the plan, taking into consideration the risk of loss, the opportunity for gain, and the portfolio's diversification, liquidity and projected return of the investment, and the cost of due diligence. ERISA holds the fiduciary, when making investment decisions, to a high standard of care so that the fiduciary acts under the standard of a professional investment expert, not under the standard of an individual with little or no investment expertise.¹⁸

In order to assist plan sponsors who are considering whether to invest pension plan assets in hedge funds and/or private equity funds, fiduciaries can use the following set of questions and answers to assist them in selecting and monitoring these types of investments.

1. *What are hedge funds and private equity funds?*

- The term "hedge fund" is commonly used to describe a pooled investment vehicle that is privately offered to institutions and other sophisticated investors where the fund is not registered (like a mutual fund or an exchange traded fund) with the SEC. The hedge fund often engages in active trading of various types of securities, commodities, derivatives, option contracts and other investment vehicles and may employ borrowing, or "leverage," techniques to help it achieve its objectives.
- The term "private equity fund" is commonly used to describe a pooled investment vehicle that is privately offered and includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange.

2. *How can I determine if a hedge fund or a private equity fund is an appropriate investment for a plan?*

- Each hedge fund and private equity fund has one or more investment strategies. Identify the fund's specific investment strategy or strategies and determine their fit to the plan's investment policy and current investment portfolio. Hedge fund strategies could include

¹⁸ The Department of Labor, in a March 21, 1996 informational letter to Eugene Ludwig, Comptroller of the Currency, noted that pension plan fiduciaries, in addition to following comprehensive standards that are part of the general procedures for investment review, would need to exercise additional understanding and sophistication when evaluating derivatives. Topics for consideration noted in this letter include operational, pricing, credit, legal, and currency risks. This assessment has been considered to apply to a broader list of alternative investments such as hedge funds and private equity investments.

global macro, event driven, equity market neutral and other strategies. Private equity strategies could include venture capital, corporate buyouts, and other strategies.

- Many hedge fund strategies are structured to produce smooth market returns in anticipation of lower volatility. Other strategies essentially give the investment manager complete discretion over the selection of investments for the fund.
- Private equity investments are structured to take advantage of different phases of a business development cycle, with different risk characteristics. Investor contributions will be structured over a period of 3-5 years, or longer, and each fund will have its own unique payout structure, thereby making the comparisons between funds difficult. This is generally true even within funds that employ similar strategies because the investment managers each have unique approaches to the selection of investments.
- Conduct research and understand the differences in the investment strategies and determine the role a selected investment strategy will play in the portfolio of the pension plan. Note if a fund has a certain geographical or market sector bias that may or may not fit with your plan.
- Consider the differences between a direct investment in a private equity or hedge fund, and an indirect investment through a fund of funds option (i.e., a fund that invests in a number of underlying hedge funds or private equity funds). Particularly for a small plan, a fund of fund approach may enable the plan to indirectly invest in funds not otherwise available to a small plan, especially since the plan would be making a smaller fund investment. The fund of funds also offers additional diversification and layers of due diligence (especially if SEC registered), in exchange for adding another layer of management fees and administrative costs. Understand the investment strategies of any underlying investment managers (“sub-managers”) of a fund of funds product.
- In all cases, meet with the managers of the fund (hedge fund, private equity fund, and fund of funds) and consider sending out a follow up Request for Information and a Due Diligence Questionnaire to the fund managers. The correspondence should include questions about their investment process, organization and fees, in addition to reviewing the fact sheet, offering memorandum, and partnership agreements applicable to the investment. Overall, evaluate the fit of the investment to the investment goals, investment policy, and other relevant goals of retirement plan, participants, and beneficiaries under the plan.

3. *What are some of the issues in evaluating the historical return and risk profile of a specific hedge fund or private equity fund investment strategy relative to a broad market index?*

- For a hedge fund investment, evaluate the annualized return and the risk (as measured by the standard deviation of return) of the investment strategy over a 7-10 year period. Compare these metrics to the metrics of a broader market-based index such as the S&P 500. Comparison to hedge fund index, such as the HFRI Composite Index, or to a subset of a hedge fund index that only includes funds with specific strategies (e.g., event driven hedge funds), may be helpful. Review the manager's use of leverage or derivatives to achieve superior performance.

- For a private equity investment, consider the track record performance of previous funds structured by the general partner, and compare to a composite index, such as Thomson Venture Economics, for similar strategies over similar investment periods.
- Understand that any index of such funds may include performance bias, such as selection and survivorship biases.

4. *Do I have the expertise and time needed to evaluate whether the hedge fund or private equity fund is appropriate for my plan?*

- Hedge funds and private equity funds can be much more complex than other investments, and generally require a greater level of investment sophistication and due diligence to evaluate the investment risks associated with the fund in both the selection of a fund, and monitoring the fund on an ongoing basis. If you do not have the expertise to make the necessary evaluation of these funds, you should hire an expert investment professional to assist you. You can also consider investing through a fund of funds and hiring an investment professional to assist you in choosing the appropriate fund of funds. The investment professional should be independent, rather than someone whose compensation depends on what he or she sells to the plan.
- Whether the assets of the pension plan are invested in the fund directly or through a fund of funds, and whether you engage an outside investment professional to assist you, you should evaluate whether all fiduciaries involved with the plan have adequate time and resources to devote to the prudent selection and monitoring of the investment.

5. *What do I need to understand about hiring an investment firm to assist me?*

- If you are hiring an investment firm to assist in the selection and monitoring of hedge fund and/or private equity investments, understand how the investment firm evaluates and monitors the fund investments in the plan's portfolio, and how the hedge fund or private equity investment enhances portfolio diversification for the plan. How frequently do they evaluate and monitor the plan's holdings?
- Ask the investment firm how they evaluate risks to the plan's portfolio and how do they control portfolio risk. Do they perform stress testing and risk analysis, and what is the state of their technology to support it? What assumptions do they make about the future and how do they develop scenarios to stress test? Are they using state of the art technology, and is it developed in-house, or do they use off-the-shelf programs? Have their investment processes or models been validated by outside experts? What is the past experience of their quantitative team? Will they perform an investment liquidity analysis?
- Understand the investment firm's due diligence process. Review how, and how often, the investment firm conducts financial analysis, operational due diligence and background checks on their personnel. Ask about their procedures to evaluate the fund's internal controls and compliance, and how would they uncover a trading fraud.

6. *How should I conduct the due diligence process before investing in a hedge fund or private equity fund?*

- You may hire an independent outside investment firm to conduct the due diligence process before investing in a hedge fund or private equity fund, or you may handle the due diligence process in house. In either case, you should anticipate that the due diligence process will be more involved from a time and cost standpoint than the process used in selecting other investments for the plan.
- The due diligence process should evaluate fund performance, investment risk, use of leverage and derivatives, credit risk, operational risk, legal risk, valuation and reporting.
- Request and check references and perform background checks on the fund and the individual managers. Request a copy of documents, such as the fund manager's compliance manual, code of ethics, and a yearly audit. Conduct a site visit.
- Understand how private equity funds create the cash flow projections that form the basis of the investment terms. In addition, for a private equity investment, review copies of any legal agreements, especially for capital calls/draw down and capital recovery at the exit. Also understand the level of liability of the general partner versus the limited partners.
- If the investment is in a fund of funds, become familiar with the underlying funds.

7. *Since hedge fund and private equity returns are highly dependent on manager expertise, how should I evaluate that expertise?*

- Discuss the level of experience and background of senior managers across all disciplines within the organization.
- Evaluate previous investment and managerial experience, including the manager's experience with other funds. Many hedge fund and private equity managers operated in traditional investment strategies prior to moving to alternative investments and may have a previous performance track record that can be evaluated.
- Understand the implications for the fund in the case of loss of a key person(s).

8. *What are some of the issues in evaluating fees? Are there additional fees being charged?*

- Fees associated with hedge fund and private equity investments may be higher and more complex than traditional investments. Most hedge fund and private equity investments have both asset-based management fee and a performance-based fee (called "carried-interest" for private equity funds). The investment manager will collect a fee for achieving an annual performance over a stated level (often called a "high water mark" or "hurdle rate"). The performance-based fee calculation can be complex, but you should understand situations that drive this fee, other fees, and how the fees are disclosed.
- Many investments have additional fees, such as upfront, placement, early redemption, and administrative fees.

- Private equity investments may impose substantial penalties if a capital commitment is not met, and special provisions for "carried interest," which is the portion of the profits that are retained by the general partner.
- If you are considering the fund of funds route to investing, understand that in addition to the fees charged by the underlying fund managers, the fund of funds will have its own fee structure, that could also include an additional asset-based management fee and a performance-based fee.
- When evaluating whether the fees being charged are appropriate for your plan, note that the fee should be evaluated according to the nature of the investment and that it may be appropriate to pay a higher fee for the services obtained.

9. *What do I need to understand about the liquidity of the hedge fund or private equity fund with respect to my plan?*

- Investigate the liquidity of the investments, and your ability to move some or all of the investment out of the fund when needed. Unlike registered investments, hedge funds and private equity funds do not have a secondary market and are not redeemable at will, and ownership cannot be terminated unless agreed upon with the investment manager. Most funds have lock-up provisions, gates, early termination rights, and pre-determined payment restrictions, any of which could delay your ability to move out of the fund.
- Strongly consider the impact of illiquidity on the plan's overall investment strategy, and the relationship of the plan's asset portfolio to its liabilities, benefits obligations, and expected payout requirements.
- For example, private equity funds are very illiquid, and could have a capital commitment period of 3-5 years and an investment could be locked up for as much as 10-15 years.
- Redemption notification periods and requirements with a considerable payment lag can be expected.

10. *What is involved in legal due diligence?*

- Ensure that the investment is consistent with the plan's investment policy.
- Utilize legal counsel that has experience with these types of funds and with ERISA plans.
- It is important that legal counsel review all the documentation that will affect the plan's rights, responsibilities and liabilities when it invests in a hedge fund, private equity fund, or a fund of funds. This will include multiple documents, such as the fund's offering memorandum, due diligence questionnaire, operating agreements, subscription agreement, and side letters.
- Determine whether the investment manager of the hedge fund, private equity fund, or the fund of funds, is a fiduciary under ERISA because the assets of the hedge fund, private equity fund, or fund of funds are ERISA plan assets. Also, evaluate whether the investment manager could become an ERISA fiduciary if there is a change in the proportion of fund assets held by ERISA plans and IRAs. Question the general partner about the access to capital as they build the fund.

- If the fund holds plan assets, it is important to assess whether the fund meets the requisite ERISA requirements, and if so, confirm that the fund manager is willing to accept and be governed by fiduciary status under ERISA.
- Determine what limitations of liability apply to the fund's investment adviser, any investment advisor engaged directly by the plan, and other agents, and whether any such limitation affects the willingness to invest the plan assets.
- Determine which jurisdiction's law will govern in the event of a dispute or for other purposes. Evaluate whether any particular venue will create additional legal difficulties for the plan in the event of litigation.
- Understand that certain investment strategies may not have a custodian based in the United States. Evaluate whether this particular factor would have an effect on your risk tolerance.
- For a private equity investment, understand the allocation of liability between the general partner structuring the investment and the limited partner investors. Search public databases for information and review regulatory documents such as Form ADV.

11. *What is involved in operational due diligence?*

- Consider the roles credit, operations, and legal support play in the investment organization.
- Review the report of the fund's independent auditors,
- How does the fund handle trading errors?
- Are there controls, checks and balances, disaster recovery, and back-up systems?
- In well run hedge fund and private equity firms, operational, credit and compliance staff will have a direct influence on investment decisions. Review the qualifications and experience of the support staff, and consider the ratio of support staff to investment/trading personnel. For private equity firms, quality legal expertise is paramount in structuring transactions and setting terms and liability.

12. *What about the third party organizations that support the hedge funds or private equity funds such as prime brokers, custodial banks, accountants and their legal counsel?*

- Third party support organizations often serve as a check- and- balance on a portfolio investment process, including a verification of portfolio holdings and valuation, in the case of a hedge fund. Consider the reputation and level of expertise of these support organizations. Request a reference about the fund manager from these organizations.
- Be attentive to potential conflicts of interest especially if the hedge fund restricts its use of a type of service provider to an organization affiliated with the hedge fund manager.

13. *What about client reporting, the level of transparency available to fund investors, and valuation of the fund's holdings?*

- Unlike mutual funds and similar investment vehicles, hedge funds may not reveal their individual strategies or holdings in their portfolio. Private equity funds may not reveal the names of the underlying companies in the fund until all capital has been committed and the fund is fully operational. However, most investment managers can present a potential investor with a relevant amount of information about their planned or actual investments.
- Question a manager on the methods used to evaluate an investment on an on-going basis, and how frequently can they provide updates, especially for illiquid instruments. For private equity, find out how they project cash flows and whether they are using alternate appraisal methods. This is especially important as they evaluate new technologies.
- It is especially important to understand how and when the assets held by the hedge fund or private equity fund will be valued and whether the valuation procedures appear to be appropriate.

D. Special Considerations for Defined Contribution Plans

The Council heard testimony about whether, and in what circumstances, hedge funds and/or private equity investments may be appropriate investments for DC plans and, in particular, in participant-directed DC plans. There was a difference of view on this issue both amongst witnesses and amongst Council members.

In her testimony, Ann Lester of J.P. Morgan Asset Management viewed hedge funds and private equity investments, along with other alternatives, as having a role in DC plans when they are available as part of a managed investment strategy, such as a target-date fund. She stated that plan sponsors must address a number of issues such as fees and other costs of such investments, plan participant communication and education, the ability of participants to understand the investments, how the investments will be made available (as part of a target-date, other managed investment option, or on a standalone basis), liquidity and the impact of the investment on the plan's overall portfolio, transparency and the economic value of the investment given the added costs and complexities. Other witnesses (Mr. Auriemma, Ms. Bovbjerg) did not see any role for hedge fund or private equity investments in DC plans.

As discussed above in Section III.C, there are securities law issues that are likely to prevent hedge funds and private equity funds from being available in almost all participant-directed DC plans unless the hedge funds and private equity funds are only made available as part of a generic investment option such as a target-date or life-cycle fund. In such case, the fund manager is responsible for determining the appropriateness of the investments for the fund being considered as an investment option.

Certain factors in the tip sheet may be helpful to plan sponsors and fiduciaries of DC plans who may be considering these investments. Note, however, that DC plans have certain unique characteristics, for example, with respect to participant communication, disclosure, and liquidity that may require special consideration.

The Council understands that there are mutual funds, exchange traded funds, and similar types of investment vehicles that may invest in some of the same instruments and investment strategies otherwise available through hedge funds. The Council did not specifically study these investment vehicles but notes their availability.

The Council also has heard that some participant-directed DC plans may allow participants to invest their accounts in hedge funds and/or private equity funds through a brokerage window available under the plan. The Council has not sufficiently covered the issues involved with this investment option, but the Council believes that those making investment decisions should be mindful of the issues raised in the report.

E. Other issues

The Council discussed whether it would recommend that DOL should consider the role of the 25 percent test on the ability of ERISA plans to invest in hedge funds (see Section III.B. above). After deliberations and discussion, the Council determined not to make any recommendations with respect to the 25% rule.

V. CONCLUSION

This report is not intended to be viewed as an endorsement by the Council of the investment of plan assets in any particular type of investment including hedge funds, private equity funds, or a fund of funds. The report acknowledges that the Council was made aware, through testimony presented, that plan sponsors are taking approaches to diversify the investment portfolio of pension plans, while seeking better plan investment returns and protection from increased market volatility. Some plan sponsors have invested plan assets in hedge funds and private equity funds in an effort to achieve these goals, some would argue, with mixed results. Recognizing that these investments are being considered more prevalent in pension plans, the Council believes that plan sponsors must understand the unique complexities of these investment options. The Council hopes that this report is helpful to DOL in providing an additional educational resource to plan sponsors who are considering or making these investments.

APPENDIX A: WITNESS SUMMARIES

Gregg Hymowitz and Jill Zelenko, Entrust Capital Inc.

Greg Hymowitz is managing partner and co-founder of EnTrust Capital, an investment advisor that primarily manages a fund of funds which invests in underlying hedge funds. Mr. Hymowitz testified regarding both the opportunities and the challenges for hedge funds in ERISA defined benefit and defined contribution plans. Mr. Hymowitz emphasized the limitations of long investments (buy and hold) in ERISA plans, many of which, he noted, significantly underperformed the targeted return on investments reflected in many defined benefit pension plan actuarial assumptions in the past decade. Mr. Hymowitz noted that from 2001-2010 hedge fund returns (measured by an industry index) were nearly double (96.3% higher) than traditional 60% equity and 40% bond investment allocation.

He also acknowledged the reluctance of plan fiduciaries to allocate a portion of plan assets to hedge funds, due to a perception of increased risk, absence of liquidity, inadequacy of regulation, lack of fee transparency, and excessive leverage. He noted the development of increasing layers of regulatory activity affecting the fund, its advisors, or both, including SEC, FINRA, CFTC, and non-U.S. regulators, as well as the presence of regular audits.

Mr. Hymowitz identified some ERISA concerns and barriers to an expansion of hedge fund investments, including:

- restrictive plan asset rules that apply if the equity stake of ERISA plans and IRAs in the fund exceeded 25%, which would impair the fund's ability to engage in certain transactions and could limit the method of compensating the advisor;
- rules outside ERISA that govern the ability of a non-registered investment, such as a hedge fund, to be offered to individual DC plan participants, many of whom would not qualify as "accredited investors" under applicable federal securities rules;
- liquidity limitations affecting the ability to process participant withdrawals;
- compliance with new fee disclosure rules, which would require disclosure of information not currently disclosed and likely to be considered proprietary.

Kenneth Heinz, Hedge Fund Research, Inc.

Kenneth Heinz is a principal of Hedge Fund Research, Inc. ("HFRI"). Since 1993 HFRI has specialized in indexation of hedge funds. The HFRI database is a comprehensive resource, available for hedge fund investors, which includes fund level detail and historical performance in assets and firm characteristics on hedge fund managers. The database currently contains approximately 9,000 hedge fund vehicles.

According to Mr. Heinz, hedge funds are defined as specialized private investment partnerships available to qualified investors which have the ability to invest in a broad array of investment

strategies and portfolio holdings, characteristically invest both long and short, and have the ability to use leverage in most cases and can employ a broad array of investment strategies which contribute to the capacity to generate uncorrelated returns.

Mr. Heinz noted that with respect to understanding issues regarding the liquidity of assets, hedge fund liquidity can range from daily liquidity to multi-year illiquidity for both asset and fund shares. Mr. Heinz advised that investors should calibrate realistic expectations for liquidity. They should also understand that hedge funds can be subject to liquidity modification under certain unfavorable market conditions. In contrast, private equity investments are characteristically illiquid in both asset and fund shares.

He also stated that hedge funds charge investors a management fee as well, in most cases, an incentive fee, which is a percentage of the net gains of the fund. These can range broadly from 0 to 25 percent and sometimes higher.

Mr. Heinz provided background on the due diligence process used by most hedge funds. Such due diligence involves a review of the organization at nearly every level that can be conducted by advisors and analysts and, among others, compliance managers and third party background check specialists. He stated that the incidence of fraud in the fourth quarter of 2008 has resulted in the increased significance and scrutiny of due diligence activities, as well as greater transparency to hedge fund investors.

He recommend that plan sponsors (1) use a hedge fund database to understand fund strategy and comparable performance within the context of the drivers of performance; (2) maintain a multi-market cycle investment horizon while understanding liquidity of both portfolio and fund shares, avoid chasing performance, and add marginally on weakness; (3) know and meet the firm's principles and portfolio managers, perform regular in-person due diligence meetings and utilize investor references and third party background checks; (4) adopt investable performance benchmarks; and 5) utilize the benefits of transparent hedge fund investment.

Lou Campagna, Chief of the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, EBSA

Lou Campagna, on behalf of EBSA, discussed the fiduciary obligations under ERISA and how ERISA applies to plan investments, including hedge funds and private equity funds (PE funds). He covered the guidance that DOL has issued regarding fiduciary conduct relating to investments, as well as prohibited transaction issues related to investment manager compensation.

Mr. Campagna referred to Section 404(a) of ERISA, covering the standard of conduct of fiduciaries such as acting prudently and in the sole interest of the plan participants and beneficiaries, investment diversification and compliance with the plan document. Mr. Campagna stated that when investing plan assets, fiduciaries must carry out their duties with the care, skill, prudence, and diligence of a knowledgeable person under similar circumstances. If the fiduciary does not have the required expertise to make an informed decision, he must consult with someone that does. Additionally, a fiduciary cannot blindly rely on recommendations from third parties to make decisions. Consideration should be given to the qualifications of the fund

manager and the fees associated with the investment. The manner in which a manager is compensated may raise prohibited transaction issues. DOL guidance on performance fees may be found in DOL advisory opinions in 1986 to BDN Management Company and Batterymarch Management Company, in 1998 to Alliance Capital Management, and in 1999 with respect to Mount Lucas Management Company, all related to the timing or amount of compensation. Performance fees are typical characteristics of hedge funds and private equity funds, and fiduciaries should understand that there is the potential for the investment manager to make riskier investments due to the greater performance potential.

Mr. Campagna stated that a plan fiduciary will have acted prudently in selecting plan investments if the plan fiduciary gives appropriate consideration relative to the plan's portfolio regarding diversification, risk, liquidity and other return characteristics, and a review of the methodology for determining fair value of the investment. Mr. Campagna stated that hedge funds or private equity funds were subject to the same rules as all other plan investments, and the fiduciary should follow the same type of analysis in making any investment decision. Additionally, he referred to the Department's Interpretative Bulletin 2008-02, which provided that an investment may not be influenced by non-economic factors and that the fiduciary has to act in accordance with the ERISA's exclusive purpose rule, which requires the fiduciary to act in the sole interest of the plan participants and beneficiaries.

Mr. Campagna stated that the most comprehensive discussion of these principles can be found in a 1996 letter to the Comptroller of the Currency, Eugene Ludwig, which focused on derivative investments (the Ludwig Letter). The letter made clear that plan fiduciaries are responsible for securing sufficient information to evaluate an investment and a duty to monitor plan investments in derivatives.

Lastly, Mr. Campagna discussed prohibited transactions in relation to hedge funds and private equity funds. He noted that ERISA provides that if ERISA plans hold 25% or more of the fund, then those who manage the entity will become fiduciaries. Most fund managers try to stay below this 25% threshold.

Russell Steenberg, BlackRock Private Equity Partners

Russell Steenberg defined private equity as "anything not traded in the public markets." He divided private equity investments into venture capital (the business of starting businesses) and "everything else."

Mr. Steenberg stated that the average asset allocation to private equity in a defined benefit plan today is around 11%, with newer investors having a lower 5% asset allocation, and more aggressive funds having a 15-20% allocation. Mr. Steenberg stated that defined benefit plans should match liability streams to assets, because private equity is totally illiquid. Private equity investments normally appear in the form of 10-year locked up partnerships contracts that generally cannot be broken. Mr. Steenberg commented that the price for liquidity must be balanced against the higher returns available historically in the private equity market (typically 300 to 500 basis points over the public market over a 10 or 20 year period) and the diversification available because

private equity assets are not correlated with other asset returns. He offered that private equity reduces the overall risk while producing a higher rate of return.

When asked about whether private equity would be feasible in defined contribution plans, Mr. Steenberg responded that many rules and regulations would have to be changed to allow private equity to become viable for 401(k) plans. He noted that daily valuations are an issue, but that the advent of new accounting rules and FASB 157 may allow for the development of commonly accepted uniform methodologies.

Mr. Steenberg advised that a plan sponsor could identify better performing managers by looking at the top quartile of managers because there is persistent performance in the private equity market, with a high probability that great performers will continue to outperform. Additional factors to be considered include turnover, the investment process and adherence to that process. He noted that fund selection is the key, rather than access to the private equity market.

Mr. Steenberg went on to describe that the plan market was split between (1) groups that had expertise and resources to pick their own partnerships; (2) groups that lacked internal resources and chose to invest in a fund of funds; and (3) groups which pick some partnerships themselves but hire a manager to fill a specific niche in their portfolio and create a separate account for that purpose.

When asked how a plan sponsor could protect the plan from adverse actions, Mr. Steenberg noted that each partnership contract is a negotiation and that there are various ways of structuring options to withdraw from an investment or to force the partnership pool to liquidate. However, the terms and conditions are agreed upon at the front end, so this requires careful thought to address issues such as if a particular manager leaves or when to allow limited partners to force liquidation.

Bruce McNeil, Littler Mendelson P.C.

Bruce McNeil, an attorney with Littler Mendelson, defined a hedge fund as a legal entity that allows investors to pool their money together, which is managed by an investment manager who exploits pricing inefficiencies in the market to generate high returns while trying to assume minimal risk. He noted that academics define hedge funds as privately offered, relatively unregulated pooled investment vehicles in the form of limited partnerships or limited liability companies that have the flexibility to invest in a wide range of securities and commodities using a broad range of trading techniques.

Mr. McNeil testified that typically a hedge fund or a private equity fund has a 1 percent or 2 percent management fee. However, the general partner of the particular fund also obtains a “profits interest” or a “carried interest,” typically around 20 percent. Depending on the method in which the fund allocates this interest, as the investment progresses the fees could become significant. As such, Mr. McNeil recommended that the Department of Labor structure regulation in terms of what might be an expectation of the fees to be paid by a plan, and if the fee is reasonable for the expected gain.

When asked about the transparency of these investments, Mr. McNeil stated that hedge funds may avoid registration under the Investment Company Act of 1940 either under section (3)(c)(1), which exempts funds that have 100 or fewer beneficial owners within the United States and do not offer securities to the general public, or through section (3)(c)(7), because the investors are all qualified purchasers. That enables hedge funds to avoid providing the level of transparency to its investors of the fund's holdings that would otherwise be required of a registered investment company. However, Mr. McNeil reported that hedge funds are not free from regulation. For instance, they are subject to the anti-fraud provisions of the securities laws.

According to Mr. McNeil, it would be difficult for defined contribution plans to be considered an "accredited investor" because a typical defined contribution plan has a self-direction component under ERISA section 404(c). However, these plans may access hedge funds through a brokerage window if the investment is with a fund of funds. He noted that a fund of funds typically is not as risky, because it invests in a series of hedge funds and presumably provide greater diversification. Mr. McNeil testified that the fund of funds vehicle is traditionally more transparent to its investors, informing them on the types of investments the fund holds.

Barbara Bovbjerg, Managing Director of Education, Workforce, and Income Security, and David Lehrer, Assistant Director of Education, Workforce, and Income Security, of the Government Accountability Office ("GAO") (also in attendance from GAO were Michael Hartnett and Amber Yancey-Carroll)

Barbara Bovbjerg provided an extensive statement for the record, GAO-11-901SP, the release of which coincided with her testimony. The statement was an update of a 2008 GAO report on the same topic. Ms. Bovbjerg noted that analysis continues in this area with a future release of study results scheduled for early 2012. The analysis indicated that defined benefit pension plans increased alternative investment allocations with 60% of large plans holding hedge funds in their portfolios today, an increase from about 11% in 2001. She noted that although over 90 percent of large plans invest in private equity, more than 70 percent of them did in 2001, so this type of investment has been fairly common. She reported that the use and allocations to alternative investments was much more prevalent among large plans in 2010 – of the 78 large plans using hedge funds, 20 had allocations of 10% or more (highest reported allocation was 33%); of the 121 plans reporting private equity investments, 34 had allocations of 10% or more (highest reported was 30%).

Ms. Bovbjerg noted that there was widespread consensus among plans using alternative investments that these investments can help a plan diversify while gaining potentially significant returns. However, she also discussed some major challenges with respect to alternative investments, in particular the:

- Uncertainty over the current value/market price of the investment,
- Greater risk involved in hedge funds from the greater use of leverage,
- Lack of portfolio composition transparency – to minimize the potential of compromising trading strategies, and

- Difficulties in valuation in that the ultimate value of the underlying holdings, particularly in private equity, won't be known with certainty until assets are sold – often as much as 10 years later.

Ms. Bovbjerg also expressed concern that plan sponsors are facing tremendous financial pressures, both overall and in maintaining funding levels in their DB plans. Although Congress provided temporary relief from ERISA funding rules, it is her opinion that the pressure to achieve high returns on plan assets is significant, especially if a failure to achieve such returns means higher required contributions to the plan in the future.

She raised concerns about a “herd mentality” of increased use of alternative investments among smaller plans noting that a plan’s ability to access top tier managers, consultants, and top-tier funds is inverse to plan size, so as the use of alternative investments becomes more extensive, there would be greater difficulty in accessing top-tier talent. She also cautioned about the use of these investments in the “401(k) world” cautioning all about offering investments to participants that experienced fiduciaries might struggle to understand.

David Lehrer noted that taking on greater levels of alternatives may result in greater levels of risk within the plan’s portfolio. He noted some plans have moved to a risk aggregator approach - a third party intermediary monitors risk at the plan level while avoiding disclosure to the plan of individual position-level information about hedge fund investments. In response to questioning from the Council about whether the investment strategy was consistent with reducing downside risk, Mr. Lehrer viewed hedge funds as an investment that would “probably not” be as high as the upside in a good market but also “hopefully not as down” in a bad market and would therefore have a role in terms of trying to manage the overall volatility of the asset allocation and the overall portfolio.

Ms. Bovbjerg concluded by reconfirming the need for greater transparency and risk mitigation with respect to these investments to help fiduciaries become more aware of the risks associated with the investments. She acknowledged that guidance from DOL, and better information from the investment managers themselves, cannot completely protect plan assets from poor decision-making, but it can better protect fiduciaries, and by extension the plan's participants, against large losses resulting from a poor understanding of the characteristics of these investments.

Samuel Gallo, Managing Director, PricewaterhouseCoopers

Sam Gallo described the characteristics of a typical hedge fund and a private fund. His testimony provided that due to the lack of standard reporting, estimating aggregate performance of hedge funds and private equity funds is difficult. Mr. Gallo explained that there is no single index that measures the performance of all hedge funds; consequently, there is an incomplete picture of the performance of hedge funds. However, his review of major indices for these types of investments demonstrate that the investment styles of both hedge funds and private equity funds have, over the past 21 years, out-performed traditional equity and fixed income benchmarks as measured by returns of the S&P 500 Total Return Index, and the Barclays Aggregate Bond Index.

According to Mr. Gallo, despite the benefits he described, there are a number of risks unique to hedge funds and private equity fund investing that need to be understood and evaluated prior to investment. Those risks vary by strategy and investment style but can include market risks, illiquidity risks, inaccurate valuation of pricing risks, operational risks, risks related to lack of regulatory oversight, risks related to a lack of transparency provided to investors, and less formalized governance risks.

Mr. Gallo emphasized that for sponsors of plans with such alternative investments, due diligence in selection of these investments and monitoring is important. Areas of focus in evaluating hedge funds and private equity investments may include an understanding of the investment strategy pursued by the fund; review of the investment processes and methodologies utilized by the manager; a review of the associated risks of the strategy; operational due diligence review of back-office risk management reporting, controls, policies, and compliance procedures; background and reference checks on key investment professionals; a legal documentation review; and a review of the portfolio construction considerations with respect to the plan's overall portfolio.

Anne Lester, Managing Director, Global Multi Asset Group, J.P. Morgan Asset Management

Anne Lester, on behalf of J.P. Morgan Asset Management, discussed how alternative asset classes such as hedge funds and private equity investments could be incorporated in defined contribution plans, and where such investments could be most appropriate. Alternative investments include direct real estate commodities, hedge funds, private equity, and venture capital and infrastructure funds. It was Ms. Lester's opinion that these alternatives trade some form of liquidity or transparency for stability of return and that such a trade-off can be important for defined contribution plans.

She advised that there should be a framework for evaluating whether to include alternative investments for DC plan sponsors. The framework should include consideration of the costs associated with any investment, such as fees, fiduciary education and management of the investment, participant understanding and knowledge, and how the investment will be made available (whether as part of a managed portfolio or as a stand-alone option), as well as operational issues. She also noted that sponsors should consider whether it is appropriate to limit the allocation of assets to alternative classes.

According to Ms. Lester, there are five key points to consider when incorporating alternative asset classes as part of managed portfolio that could be included in a defined contribution plan investment option: (1) liquidity and the impact on the entire portfolio; (2) transparency and the ability to understand the strategy and benchmark performance; (3) the economic value of the investment and the ability to predict return; (4) volatility of the investment and its relationship to other assets in the portfolio; and (5) the level of fees. The method of assessing any performance fee needs to be considered, as there are challenges in determining its allocation among participants.

Ms. Lester explained that her firm has concluded that alternative assets are best offered in DC plans as part of a professionally managed portfolio, such as a managed account or target-date

fund. As a manager of J.P. Morgan Asset Management, she uses aspects of hedge fund investment strategies in target-date funds and has done so for six years. In participant communications about these target-date funds with some allocation to hedge funds or alternative asset classes, facts sheets describing asset classes and the risks and other information about such assets are provided. She does not recommend using alternative asset funds as a direct investment for DC plan participants due to the lack of liquidity and the high risk of concentration.

Angelo Auriemma, Investment Advisor, Plan Sponsor Advisors

Angelo Auriemma, an investment advisor for plan sponsors, testified on the appropriateness of hedge and private equity fund investments in retirement plans. He addressed separately the specific issues plan sponsors must consider if investing through DB and DC plans.

Regarding DB plans, Mr. Auriemma remarked that hedge funds and private equity funds have been utilized by larger plans for some time. He noted that provided these plan sponsors have the ability to make informed decisions, these investment vehicles can be appropriate because of their diversification potential. In particular he noted, they can help DB plans better match asset duration with liability duration (“immunization”).

However, he cautioned that many DB plan sponsors do not have the expertise to perform the appropriate due diligence on these products or to evaluate their consultant’s recommendations. It was Mr. Auriemma’s view that hedge funds and private equity have not outperformed traditional equities in all asset classes.

Regarding DC plans, Mr. Auriemma strongly emphasized that hedge funds and private equity investments are not appropriate as standalone investment options. He outlined six reasons for this conclusion:

1. The restricted liquidity of these investments makes such investments incompatible with the flexibility/liquidity needs required by DC plans;
2. The complexity of these investments can be difficult for plan sponsors to understand. Moreover, the capacity of hedge funds to produce returns is highly dependent on keeping their strategies secret, which is contrary to providing transparency;
3. Higher fees typically associated with hedge funds and private equity investments may be contrary to the low fee objective for retirement plans;
4. These investments are not well suited to daily valuation and pose a significant barrier for DC plans;
5. The lack of regulation of many hedge funds and private equity investments is a concern; and
6. DC plans are typically handled by administrative and human resources staff rather than those with finance expertise. As a result, most DC plan sponsors do not have the training to adequately evaluate and monitor the risks inherent in investing in hedge funds and private equity funds.

Jennifer Eller, Groom Law Group

Jennifer Eller is an employee benefits lawyer practicing with the Groom Law Group. She counsels and provides advice to plan sponsors in connection with ERISA, including plan investments such as hedge funds and private equity funds.

Ms. Eller praised the “brilliance of ERISA’s prudence rule” based upon the premise that it allows for development and growth as a “living standard”... and that it is “not a list of do’s and don’ts.” It is her view that due to this flexibility, DOL has been able to expand on the statutory definition of prudence and its requirements.

Ms. Eller discussed the prudence rule and its requirements that a fiduciary “has to give appropriate consideration to facts and circumstances relevant to the particular investment course of action, including the role the investment plays in the plan’s investment portfolio, and then act accordingly...very notably, a focus of the analysis and the prudence requirement is in the process itself in...reaching the particular decision involving the investment.” Ms. Eller observed that pursuant to the Preamble to the prudence regulation that “while a prudent process obviously involves and assessment of risk, risk of loss and potential for gain of an investment, that if, after making due consideration of all the facts and circumstances that there’s no investment that’s off limits, even an investment that would have a relatively high degree of risk under the prudence rule so long as [the fiduciary] has gone through the appropriate process.” Ms. Eller referred to the Ludwig Letter issued by the DOL and its approach on the investment of derivatives at the time (1996) as an example of an earlier application of the principles of the Preamble.

Ms. Eller focused on parts of the Ludwig Letter that are practical in evaluating the appropriateness of hedge fund and private equity investments. She spoke of the duty to evaluate legal risk, to assure proper documentation of the transaction or the contract that governs the transaction (e.g., reviewing the investment management contract); monitoring the investment and the frequency and degree of monitoring, depending on the nature of the investment and the role the investment will take in the plans’ portfolio.

Regarding the use of these investments in DC plans, she indicated that one of the possible reasons that she believes that DB plans tend to outperform DC plans is that DB plans have greater diversification. In order for participants in DC plans to access alternative investments, Ms. Eller explained that she thinks it’s possible for a DC fiduciary committee to undertake a prudent process in selecting and monitoring plan options that contain these investments, and that the process would be pretty much identical to a DB plan fiduciary process. However, she also thinks that the fiduciary in the DC plan might have concerns about a greater likelihood of legal liability for having these investments in a DC plan. It is her view that there is a tremendous focus on fees in the DC plan marketplace and that since hedge funds and private equity funds require active management, more active management of plans will cost more, which on the mere surface could be a deterrent. She also cited liquidity concerns regarding these investments. Although there is no legal requirement to provide a daily valuation for participants, the DC plans have evolved so that they are basically daily valued.